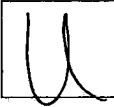


ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

<p>E-04204A UNS Electric, Inc. Attn: David Couture PO Box 711, MS UE201 Tucson, AZ 85702</p> <p>RECEIVED</p>	
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ACC UTILITIES DIRECTOR

ANNUAL REPORT
Electric

FOR YEAR ENDING

12	31	2009
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FOR COMMISSION USE

ANN 01	09
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4-26-10

COMPANY INFORMATION

Company Name (Business Name) UNS Electric, Inc.

Mailing Address P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

Local Office Mailing Address P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Local Office Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

MANAGEMENT INFORMATION

☐ **Regulatory Contact:**

☐ **Management Contact:** David Couture

(Name)

Director, Government Relations

(Title)

P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

On Site Manager:

Bill DeJulio, General Manager Electric Operations, Mohave

(Name)

David Thomas, T&D Operations General Manager

(Name)

2498 Airway Ave.

(Street)

Kingman, AZ

(City)

(State)

86402

(Zip)

(928) 681-8902

Telephone No.
(Include Area Code)

(928) 681-8915

Fax No.
(Include Area Code)

N/A

Cell No.
(Include Area Code)

4350 E. Irvington Rd./P.O. Box 711 Tucson, AZ

(Street)

(City)

(State)

(Zip)

85702

(520) 745-3429

Telephone No.
(Include Area Code)

(520) 571-4101

Fax No.
(Include Area Code)

N/A

Cell No.
(Include Area Code)

Email Address bdejulio@uesaz.com

dthomas@tep.com

Statutory Agent: _____		Diana K. Durako	
		(Name)	
P.O. Box 711, Mail Stop UE-201	Tucson	Arizona	85702
(Street)	(City)	(State)	(Zip)
(520) 571-4000 ext. 3652	(520) 884-3601	N/A	
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)	
Attorney: _____		Raymond S. Heyman	
		(Name)	
P.O. Box 711, Mail Stop UE-183	Tucson	Arizona	85702
(Street)	(City)	(State)	(Zip)
(520) 571-4000	(520) 884-3612	N/A	
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)	
Email Address <u>rheyman@tep.com</u>			

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- | | |
|---|--|
| <input type="checkbox"/> Sole Proprietor (S) | <input checked="" type="checkbox"/> C Corporation (C) (Other than Association/Co-op) |
| <input type="checkbox"/> Partnership (P) | <input type="checkbox"/> Subchapter S Corporation (Z) |
| <input type="checkbox"/> Bankruptcy (B) | <input type="checkbox"/> Association/Co-op (A) |
| <input type="checkbox"/> Receivership (R) | <input type="checkbox"/> Limited Liability Company |
| <input type="checkbox"/> Other (Describe) _____ | |

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

- | | | |
|--|-----------------------------------|--|
| <input type="checkbox"/> APACHE | <input type="checkbox"/> COCHISE | <input type="checkbox"/> COCONINO |
| <input type="checkbox"/> GILA | <input type="checkbox"/> GRAHAM | <input type="checkbox"/> GREENLEE |
| <input type="checkbox"/> LA PAZ | <input type="checkbox"/> MARICOPA | <input checked="" type="checkbox"/> MOHAVE |
| <input type="checkbox"/> NAVAJO | <input type="checkbox"/> PIMA | <input type="checkbox"/> PINAL |
| <input checked="" type="checkbox"/> SANTA CRUZ | <input type="checkbox"/> YAVAPAI | <input type="checkbox"/> YUMA |
| <input type="checkbox"/> STATEWIDE | | |

SERVICES AUTHORIZED TO PROVIDE

Check the following box/es for the services that you are authorized to provide:

☒ **Electric**

- ☒ Investor Owned Electric
- ☐ Rural Electric Cooperative
- ☐ Utility Distribution Company
- ☐ Electric Service Provider
 - ☐ Transmission Service Provider
 - ☐ Meter Service Provider
 - ☐ Meter Reading Service Provider
 - ☐ Billing and Collection
 - ☐ Ancillary Services
 - ☐ Generation Provider
 - ☐ Aggregator/Broker

☐ **Other** (Specify) _____

STATISTICAL INFORMATION

Total number of customers (at 12/31/2009)	90,282	
Residential	79,641	
Commercial	10,335	
Industrial	24	
Public Street and Highway lighting	267	
Irrigation	-	
Resale	15	
 Total kilowatt-hours sold	1,938,174,827	kWh
Residential	813,795,407	
Commercial	607,928,052	
Industrial	360,458,511	
Public street and highway lighting	2,219,857	
Irrigation	-	
Resale	153,773,000	
 Maximum Peak Load	559	MW

COMPANY NAME: UNS Electric, Inc.

UTILITY SHUTOFFS / DISCONNECTS

MONTH		Termination without Notice R14-2-211.B	Termination with Notice R14-2-211	OTHER
JANUARY			750	
FEBRUARY			438	
MARCH			542	
APRIL			518	
MAY			470	
JUNE			613	
JULY			454	
AUGUST			599	
SEPTEMBER			551	
OCTOBER			652	
NOVEMBER			577	
DECEMBER			528	
TOTALS →			6,692	

OTHER (description):

**VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only**

RECEIVED

ACC UTILITIES DIRECTOR

VERIFICATION

STATE OF Arizona

**I, THE UNDERSIGNED
OF THE**

COUNTY OF (COUNTY NAME)
Pima
NAME (OWNER OR OFFICIAL) TITLE
Karen G. Kissinger, VP, Controller & Chief Compliance Officer
COMPANY NAME
UNS Electric, Inc.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2009

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2009 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$)

\$ 198,427,486

**(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 13,876,700
IN SALES TAXES BILLED, OR COLLECTED)**

****REVENUE REPORTED ON THIS PAGE MUST
INCLUDE SALES TAXES BILLED OR
COLLECTED. IF FOR ANY OTHER REASON,
THE REVENUE REPORTED ABOVE DOES NOT
AGREE WITH TOTAL OPERATING REVENUES
ELSEWHERE REPORTED, ATTACH THOSE
STATEMENTS THAT RECONCILE THE
DIFFERENCE. (EXPLAIN IN DETAIL)**


SIGNATURE OF OWNER OR OFFICIAL

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

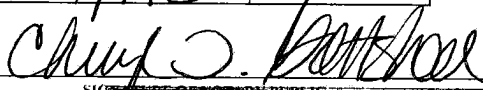
THIS

1st

DAY OF

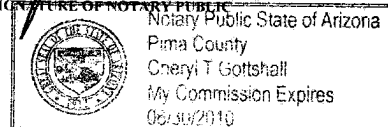
(SEAL)

COUNTY NAME
Pima
MONTH
April
2010


SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES

06/30/2010



**VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY**

RECEIVED

ACC UTILITIES DIRECTOR

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME) Pima	
NAME (OWNER OR OFFICIAL) Karen G. Kissinger	TITLE VP, Contr. & Chief Compl. Officer
COMPANY NAME UNS Electric, Inc.	

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2009

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2009 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES

\$ 90,756,268

(THE AMOUNT IN BOX AT LEFT
INCLUDES \$ 6,346,890

IN SALES TAXES BILLED, OR COLLECTED

*RESIDENTIAL REVENUE REPORTED ON THIS PAGE
MUST INCLUDE SALES TAXES BILLED.

Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS

1st

DAY OF

(SEAL)

MY COMMISSION EXPIRES

06/30/2010

NOTARY PUBLIC NAME Cheryl T. Gottshall	
COUNTY NAME Pima	
MONTH April	2010

Cheryl T. Gottshall
Notary Public, State of Arizona
My Commission Expires
06/30/2010

FINANCIAL INFORMATION

Attach to this annual report a copy of the Company year-end (Calendar Year 2009) financial statements. If you do not compile these reports, the Utilities Division will supply you with blank financial statements for completion and filing. **ALL INFORMATION MUST BE ARIZONA-SPECIFIC AND REFLECT OPERATING RESULTS IN ARIZONA.**

UNS Electric, Inc.
Financial Statements
Years Ended December 31, 2009 and 2008



Report of Independent Auditors

To the Board of Directors and Stockholder of
UNS Electric, Inc.

In our opinion, the accompanying balance sheets and statements of capitalization and the related statements of income, cash flows, changes in stockholder's equity and comprehensive income present fairly, in all material respects, the financial position of UNS Electric, Inc. (the "Company") at December 31, 2009 and December 31, 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
April 5, 2010

UNS ELECTRIC, INC.
STATEMENTS OF INCOME

	Years Ended December 31,	
	2009	2008
	- Thousands of Dollars -	
Operating Revenues		
Electric Retail Sales	\$ 180,103	\$ 183,084
Electric Wholesale Sales	5,342	10,168
Other Revenues	1,827	1,658
Total Operating Revenues	187,272	194,910
Operating Expenses		
Fuel		
Purchased Energy	17,665	10,294
Transmission	101,047	125,208
Decrease to Reflect PPFA Recovery Treatment	10,702	10,605
Total Fuel and Purchased Energy	(1,734)	(2,745)
Other Operations and Maintenance	127,680	143,362
Depreciation and Amortization	25,661	22,231
Taxes Other than Income Taxes	14,012	13,574
Total Operating Expenses	4,202	3,694
Operating Income	171,555	182,861
	15,717	12,049
Other Income		
Interest Income		
Other	63	207
Total Other Income	626	519
	689	726
Interest Expense		
Long-Term Debt		
Interest on Capital Leases	6,870	6,546
Other Interest Expense	12	20
Interest Capitalized	255	218
Total Interest Expense	(415)	(182)
	6,722	6,602
Income Before Income Taxes		
Income Tax Expense	9,684	6,173
	3,753	2,409
Net Income	\$ 5,931	\$ 3,764

See Notes to Financial Statements.

UNS ELECTRIC, INC.
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2009	2008
	- Thousands of Dollars -	
Cash Flows from Operating Activities		
Cash Receipts from Electric Retail Sales	\$ 200,178	\$ 196,541
Performance Deposit Receipts	12,880	24,250
Income Tax Refunds Received	5,371	487
Cash Receipts from Electric Wholesale Sales	5,198	9,410
Customer Deposits Received	2,300	1,809
Interest Received	134	179
Cash Receipts from Gas Wholesale Sales	8	-
Other Cash Receipts	144	144
Purchased Energy Costs Paid	(99,735)	(125,975)
Payment of Other Operations and Maintenance Costs	(20,762)	(18,586)
Fuel Costs Paid	(18,945)	(8,152)
Taxes Paid, Net of Amounts Capitalized	(18,859)	(17,789)
Payment of Affiliate Charges	(8,159)	(5,171)
Interest Paid, Net of Amounts Capitalized	(6,788)	(5,019)
Performance Deposit Payments	(6,260)	(30,870)
Wages Paid, Net of Amounts Capitalized	(5,708)	(5,549)
Income Taxes Paid	(3,257)	(1,200)
Other Cash Payments	(767)	(958)
Net Cash Flows - Operating Activities	36,973	13,551
Cash Flows from Investing Activities		
Capital Expenditures	(28,037)	(29,664)
Proceeds from Sale of Land and Buildings	3	80
Net Cash Flows - Investing Activities	(28,034)	(29,584)
Cash Flows from Financing Activities		
Proceeds from Issuance of Long-Term Debt	-	100,000
Payments to Retire Long-Term Debt	-	(60,000)
Proceeds from Borrowings under Revolving Credit Facility	-	26,000
Repayment of Borrowings under Revolving Credit Facility	(8,000)	(44,000)
Equity Investment from UniSource Energy Services	-	270
Customer Advance Receipts	875	1,326
Customer Advance Refunds	(328)	(718)
Other Cash Payments	(101)	(706)
Net Cash Flows - Financing Activities	(7,554)	22,172
Net Increase in Cash and Cash Equivalents	1,385	6,139
Cash and Cash Equivalents, Beginning of Period	8,806	2,667
Cash and Cash Equivalents, End of Period	\$ 10,191	\$ 8,806

See Notes to Financial Statements.

UNS ELECTRIC, INC.
BALANCE SHEETS

	December 31,	
	2009	2008
	- Thousands of Dollars -	
ASSETS		
Utility Plant		
Plant in Service	\$ 248,344	\$ 223,098
Utility Plant under Capital Leases	706	706
Construction Work in Progress	19,493	18,758
Total Utility Plant	268,543	242,562
Less Accumulated Depreciation and Amortization	(52,509)	(39,126)
Less Accumulated Amortization of Capital Lease Assets	(584)	(492)
Total Utility Plant - Net	215,450	202,944
Investments and Other Property	521	521
Current Assets		
Cash and Cash Equivalents	10,191	8,806
Accounts Receivable - Retail and Other	8,841	11,664
Unbilled Accounts Receivable	6,348	9,992
Accounts Receivable - Wholesale	112	115
Allowance for Doubtful Accounts	(995)	(1,379)
Accounts Receivable - Due from Affiliates	1,308	4,912
Income Tax Receivable	-	108
Materials and Supplies	9,633	8,984
Regulatory Assets - Derivative Instruments	9,268	16,571
Energy Contracts - Derivative Instruments	1,539	1,585
Deferred Income Taxes - Current	882	704
Regulatory Assets - Other	230	260
Collateral Posted for Derivative Contracts	-	6,620
Other	805	1,005
Total Current Assets	48,162	69,947
Other Assets		
Energy Contracts - Derivative Instruments	3,315	1,517
Regulatory Assets - Derivative Instruments	2,344	7,214
Regulatory Assets - Pension and Other Postretirement Benefits	1,918	2,575
Unamortized Debt Discount and Expense	625	728
Regulatory Assets - Other	442	243
Preliminary Engineering	418	368
Other	16	4
Total Other Assets	9,078	12,649
Total Assets	\$ 273,211	\$ 286,061

See Notes to Financial Statements.

(Balance Sheets Continued)

**UNS ELECTRIC, INC.
BALANCE SHEETS**

	December 31,	
	2009	2008
	- Thousands of Dollars -	
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity	\$ 89,618	\$ 83,755
Capital Lease Obligations	38	147
Long-Term Debt	100,000	108,000
Total Capitalization	189,656	191,902
Current Liabilities		
Current Obligations under Capital Leases	109	103
Accounts Payable - Purchased Energy	6,205	5,849
Accounts Payable	3,777	4,822
Accounts Payable - Due to Affiliates	4,737	6,785
Energy Contracts - Derivative Instruments	10,806	18,156
Customer Deposits	4,915	4,066
Regulatory Liability - Over-Recovered Purchased Energy Costs	4,753	6,459
Accrued Taxes Other than Income Taxes	3,599	4,086
Interest Accrued	2,709	2,870
Accrued Employee Expenses	1,194	1,167
Regulatory Liabilities - Other	531	1,078
Other	2,486	100
Total Current Liabilities	45,821	55,541
Deferred Credits and Other Liabilities		
Customer Advances for Construction	12,093	12,606
Regulatory Liability - Net Cost of Removal for Interim Retirements	11,970	10,548
Energy Contracts - Derivative Instruments	5,659	8,731
Deferred Income Taxes	5,010	2,908
Deferred Employee Benefits	2,981	3,716
Other	21	109
Total Deferred Credits and Other Liabilities	37,734	38,618
Total Capitalization and Liabilities	\$ 273,211	\$ 286,061

See Notes to Financial Statements.

(Balance Sheets Concluded)

UNS ELECTRIC, INC.
STATEMENTS OF CAPITALIZATION

			December 31,	
			2009	2008
COMMON STOCK EQUITY			- Thousands of Dollars -	
Common Stock—No Par Value			\$ 58,887	\$ 58,887
Shares Authorized	2009	2008		
Shares Outstanding	1,000	1,000		
Accumulated Earnings	1,000	1,000		
Total Common Stock Equity			30,731	24,868
			89,618	83,755
CAPITAL LEASE OBLIGATIONS				
Total Capital Lease Obligations			147	250
Less Current Maturities			(109)	(103)
Total Long-Term Capital Lease Obligations			38	147
LONG-TERM DEBT				
Issue	Maturity	Interest Rate		
Senior Unsecured Notes - Series A	8/7/2015	6.50%	50,000	50,000
Senior Unsecured Notes - Series B	8/7/2023	7.10%	50,000	50,000
Credit Agreement - Revolving Credit Facility	8/11/2011	Variable	-	8,000
Total Long-Term Debt			100,000	108,000
Total Capitalization			\$ 189,656	\$ 191,902

See Notes to Financial Statements.

UNS ELECTRIC, INC.
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY AND COMPREHENSIVE INCOME

	Common Shares Outstanding	Common Stock	Accumulated Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholder's Equity
- Thousands of Dollars -					
Balances at December 31, 2007	1,000	\$ 58,617	\$ 21,140	\$ 32	\$ 79,789
Impact of Change in Pension Plan Measurement Date	-	-	(36)	-	(36)
Comprehensive Income:					
2008 Net Income	-	-	3,764	-	3,764
Employee Benefit Obligations					
Amortization of net actuarial loss and prior service credit included in net periodic benefit cost (net of \$1 income taxes)	-	-	-	(1)	(1)
Reclassification of Postretirement Benefit to Regulatory Asset (net of \$20 income taxes)	-	-	-	(31)	(31)
Total Comprehensive Income					3,732
Equity Contribution from UniSource Energy Services	-	270	-	-	270
Balances at December 31, 2008	1,000	\$ 58,887	\$ 24,868	\$ -	\$ 83,755
Impact of Prior Years' Adjustment - Stock Based Compensation	-	-	(68)	-	(68)
Comprehensive Income:					
2009 Net Income	-	-	5,931	-	5,931
Total Comprehensive Income					5,931
Balances at December 31, 2009	1,000	\$ 58,887	\$ 30,731	\$ -	\$ 89,618

See Notes to Financial Statements.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS

UNS Electric, Inc. (UNS Electric) is an electric transmission and distribution company serving approximately 90,000 retail customers in Mohave and Santa Cruz counties. UniSource Energy Services, Inc. (UES), an intermediate holding company, owns all of the common stock of UNS Electric and UNS Gas, Inc. UniSource Energy Corporation (UniSource Energy) owns all of the common stock of UES.

References to "we" and "our" are to UNS Electric.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

UNS Electric's accounting policies conform to accounting principles generally accepted in the United States of America (GAAP), including the accounting principles for rate-regulated enterprises.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

ACCOUNTING FOR RATE REGULATION

The Arizona Corporation Commission (ACC) and the Federal Energy Regulatory Commission (FERC) regulate portions of UNS Electric's utility accounting practices and electric rates. The ACC has authority over certain rates charged to retail customers, the issuance of securities, and transactions with affiliated parties. The FERC regulates UNS Electric's rates for wholesale power sales and interstate transmission services.

UNS Electric generally uses the same accounting policies and practices used by unregulated companies. However, sometimes regulatory accounting requires rate-regulated companies to apply special accounting treatment to show the effect of rate-regulation. For example, the ACC can determine that UNS Electric is allowed to recover certain expenses, but at a designated time in the future. In this situation, UNS Electric defers these items and shows them as regulatory assets on the balance sheet until it is allowed to charge its customers. UNS Electric then amortizes these items as expenses as it recovers these charges from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced. We evaluate our regulatory assets each period and believe recovery is probable.

The conditions a rate-regulated company must satisfy to apply regulatory accounting policies and practices include:

- An independent regulator sets rates;
- The regulator sets the rates to recover the specific costs of delivering service; and
- The service territory lacks competitive pressures to reduce rates below the rates set by the regulator. See Note 3.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

UTILITY PLANT

UNS Electric reports its utility plant at cost. Utility plant includes material and labor costs, contractor costs, construction overhead costs, and an allowance for funds used during construction (AFUDC). We charge maintenance and repairs to operating expense as incurred.

AFUDC represents the estimated cost of debt and equity funds that finance utility plant construction. We recover AFUDC in rates through depreciation expense over the useful life of the related asset. UNS Electric imputed the cost of capital on construction expenditures at an average rate of 7.62% for 2009 and 8.84% for 2008. The component of AFUDC attributable to borrowed funds is shown as Interest Capitalized, a reduction of Interest Expense, on the income statement and totaled \$0.4 million in 2009 and \$0.2 million in 2008. The equity component is included in Interest Income and totaled \$0.5 million in 2009 and \$0.3 million in 2008.

We compute depreciation of utility plant on a straight-line basis over the service lives of the assets. The average annual depreciation rates for UNS Electric's utility plant were 4.33% in 2009 and 4.47% in 2008.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

MATERIALS AND SUPPLIES

UNS Electric carries materials and supplies in inventory at the lower of average cost or market.

COMPUTER SOFTWARE COSTS

UNS Electric capitalizes costs incurred to purchase and develop computer software for internal use and amortizes those costs over the estimated economic life of the product. UNS Electric immediately expenses capitalized computer software costs if the software is determined to be no longer useful.

DEFERRED FINANCING COSTS

We defer costs related to the issuance of debt. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs. We amortize these costs over the life of the debt using the straight-line method, which approximates the effective interest method. Unamortized debt issuance costs are shown as Unamortized Debt Discount and Expense on the balance sheets. See Note 5.

UTILITY OPERATING REVENUES

UNS Electric records utility operating revenues when services are provided or commodities are delivered to customers. Operating revenues include unbilled revenues which are earned (service has been provided) but not billed by the end of an accounting period.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Amounts delivered are determined through systematic monthly readings of customer meters. At the end of the month, the usage since the last meter reading is estimated and the corresponding unbilled revenue is calculated. Unbilled revenue is calculated based on daily generation or purchased volumes, estimated customer usage by class, estimated line losses and estimated average customer rates. Accrued unbilled revenues are reversed the following month when actual billings occur. The accuracy of the unbilled revenue estimate is affected by factors that include fluctuations in energy demands, weather, line losses, and changes in the composition of customer classes.

UNS Electric has a rate-adjustment mechanism in place that allows for a revenue surcharge or surcredit (that adjusts the customer's base rate for delivered purchased power) to collect or return under- or over-recovery of costs. This rate-adjustment mechanism is revised periodically and may increase or decrease the level of costs recovered through retail rates for any difference between the total amount collected under the clause and the recoverable costs incurred. See Note 3.

We record an Allowance for Doubtful Accounts to reduce accounts receivable for revenue amounts that are estimated to be uncollectible. UNS Electric establishes an allowance for doubtful accounts based on historical experience and any specific customer collection issues that are identified.

Other Revenues primarily consist of miscellaneous fees, including service connection and late fees, and rental revenue from pole attachments.

PURCHASED ENERGY COSTS

UNS Electric defers differences between purchased energy costs and the recovery of such costs in rates. Where applicable, fuel cost over-recoveries (the excess of fuel costs recovered in base rates over fuel costs incurred) are deferred as current regulatory liabilities and under-recoveries (the excess of fuel costs incurred over fuel costs recovered in base rates) are deferred as current regulatory assets. See Note 3.

RELATED PARTY TRANSACTIONS

UNS Electric receives certain corporate, operation and administrative support services from affiliates. These costs consist primarily of employee compensation and benefits. Tucson Electric Power Company (TEP), a regulated public utility serving retail electric customers in southern Arizona, is UniSource Energy's largest operating subsidiary. Services from TEP totaled \$9 million in 2009 and \$8 million in 2008. Services from UNS Gas totaled \$0.2 million in 2009 and \$0.1 million in 2008. Southwest Energy Solutions, Inc., another UniSource Energy affiliate, charged UNS Electric \$1 million in 2009 and 2008 for meter reading services.

In 2008, TEP and UNS Electric began selling power to each other at prices based on the Dow Jones Four Corners Daily Index. TEP had wholesale power sales to UNS Electric of \$23 million and \$24 million in 2009 and 2008, respectively. UNS Electric had wholesale power sales of \$4 million to TEP in 2009 and \$9 million in 2008.

In 2009 and 2008, TEP charged UNS Electric \$3 million and \$2 million, respectively, for control area services.

In May 2008, UED began providing energy from its Black Mountain Generating Station (BMGS) to UNS Electric, through a power sale agreement. UED charged UNS Electric \$12 million in 2009 and \$7 million in 2008 for this energy. UNS Gas charged UNS Electric \$5 million for gas used by BMGS in 2009 and \$7 million in 2008.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Balances arising from transactions with affiliates are recorded on the balance sheets as Accounts Receivable – Due from Affiliates or Accounts Payable – Due to Affiliates.

INCOME TAXES

GAAP requires us to report some of our assets and liabilities differently for our financial statements than we do for income tax purposes. We reflect the tax effects of these differences as deferred income tax assets or liabilities in our balance sheets. We measure these deferred tax assets and liabilities using current income tax rates. Federal and state income tax credits are accounted for as a reduction of income tax expense in the year in which the credit arises.

Tax benefits are recognized in the financial statements when it is more likely than not that a tax position will be sustained upon examination by the tax authorities based on the technical merits of the position. The tax benefit recorded is the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authority. In calculating the benefit to be recognized we assume the tax authorities have full knowledge of the position and all relevant facts. Interest Expense includes interest accrued by UES on tax positions taken on tax returns which have not been reflected in the financial statements.

UNS Electric is a member of the UniSource Energy consolidated income tax filing. UNS Electric is allocated income taxes based on its taxable income and deductions as reported in the UniSource Energy consolidated and/or combined tax return filings. The tax liability is allocated in accordance with the income tax regulations. As a result, the regular and AMT tax liability of UNS Electric is calculated on a stand alone basis and the liability is then owed to UniSource Energy through intercompany accounts. UniSource Energy has the ultimate responsibility for payment of consolidated tax liabilities to taxing authorities and maintaining intercompany tax accounts with its subsidiaries.

TAXES OTHER THAN INCOME TAXES

UNS Electric acts as a conduit or collection agent for excise tax (sales tax) as well as franchise fees and regulatory assessments. UNS Electric records liabilities payable to governmental agencies when it charges its customers for these amounts. Neither the amounts charged nor payable are reflected in the income statement.

RENEWABLE ENERGY STANDARDS TARIFF (REST) AND RENEWABLE ENERGY CREDITS (RECs)

Arizona adopted a mandatory renewable portfolio standard that requires UNS Electric to engage in renewable energy activities, allowing cost recovery under REST. Arizona uses RECs as a form of measurement of compliance to the REST requirements encouraging construction and consumption of renewable energy. RECs are created each time one KWh of renewable energy is generated or when qualifying renewable equipment is manufactured. An escalating percentage of retail electric sales determine the annual REC requirement. RECs may be used to satisfy compliance requirements anytime after creation with no expiration date. We have the option of generating our own RECs, or purchasing RECs which are usually bundled with renewable power purchases. RECs may be sold if we do not need them for operations.

DERIVATIVE FINANCIAL INSTRUMENTS

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

UNS Electric is exposed to energy price risk associated with its purchased power requirements, volumetric risk associated with its seasonal load and operational risk associated with its generation, transmission and transportation systems. The energy price risk is mitigated through the PPFAC mechanism which provides an adjustment to UNS Electric's retail rates to recover the actual costs of purchased power, transmission and transportation. UNS Electric further reduces its risks through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability for UNS Electric; to ensure UNS Electric can meet its load and reserve requirements; and reducing UNS Electric's exposure to price volatility that may result from delayed recovery under the PPFAC. See Note 3 for further information regarding regulatory matters.

We consider the effect of counterparty credit risk in determining the fair value of derivative instruments that are in a net asset position, after incorporating collateral posted by counterparties, and allocate the credit risk adjustment to individual contracts. We also consider the impact of our own credit risk, after considering collateral posted, on instruments that are in a net liability position and allocate the credit risk adjustment to all individual contracts.

We present cash collateral and derivative assets and liabilities, associated with the same counterparty, separately in our financial statements and we bifurcate all derivatives into their current and long-term portions on the balance sheet.

Cash Flow Hedges

UNS Electric has no cash flow hedges.

Mark-to-Market

UNS Electric enters into derivatives, such as fixed price forward power purchase contracts, natural gas-indexed forward power purchase contracts and financial gas swaps, to hedge a portion of its purchased power requirements exposure. In April 2009, UNS Electric also began using call and put options, creating price stability and reducing exposure to price volatility that may result in delayed recovery under the PPFAC. These contracts are considered mark-to-market transactions. As UNS Electric's PPFAC mechanism permits recovery of the prudent costs of hedging transactions, unrealized gains and losses resulting from changes in the market prices of such contracts are recorded as either a regulatory asset or regulatory liability.

Normal Purchase and Normal Sale

UNS Electric enters into forward energy purchase and sales contracts, including call options, to support the current load forecast. When these contracts are entered into with counterparties that have generating capacity or load serving requirements, these contracts are not required to be marked-to-market and are accounted for on an accrual basis. UNS Gas enters into forward gas purchases, based on forecasted needs, with counterparties that can supply its physical gas requirements. These contracts meet the normal purchase scope exception and are not required to be marked to market. On an ongoing basis, we evaluate our counterparties for non-performance risk to ensure such risk does not impact our ability to obtain the normal scope exception.

FAIR VALUE OF FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

The fair value of a financial instrument is the market price that would be received to sell an asset or transfer a liability at the measurement date.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

UNS Electric's senior unsecured notes of \$100 million, outstanding at December 31, 2009 and December 31, 2008, have estimated fair values of \$107 million and \$97 million, respectively. UNS Electric used quoted market prices, where available, or calculated the present value of remaining cash flows at the balance sheet date using current market rates for bonds with similar characteristics with respect to credit rating and time-to-maturity. We also incorporate the impact of our own credit risk using a credit default swap rate when determining the fair value of fixed rate long-term debt.

The use of different market assumptions and/or estimation methodologies may yield different estimated fair value amounts.

Outstanding borrowings under the revolving credit facility of \$8 million at December 31, 2008 had an estimated fair value of \$8 million. UNS Electric considers the principal amounts of variable rate debt to be a reasonable estimate of their fair value.

EVALUATION OF ASSETS FOR IMPAIRMENT

UNS Electric evaluates its Utility Plant and other long-lived assets for impairment whenever events or circumstances occur that may indicate the carrying value of the assets may be impaired. If the fair value of the asset, determined based on the undiscounted expected future cash flows, is less than the carrying value of the asset, an impairment charge would be recorded.

ASSET RETIREMENT OBLIGATIONS

UNS Electric does not currently have any asset retirement obligations.

UNS Electric records cost of removal for its transmission and distribution assets through depreciation rates and recovers those amounts in rates charged to its customers. There are no legal obligations associated with these assets. UNS Electric records its obligation for estimated costs of removal as regulatory liabilities.

COMPREHENSIVE INCOME

UNS Electric had no elements of Accumulated Other Comprehensive Income (AOCI) in 2009. Beginning in 2008, UNS Electric records changes in its other postretirement obligation, not yet reflected in net periodic benefit cost, as a regulatory asset; as such amounts are probable of future recovery in rates. Amounts previously recorded in AOCI were reclassified to a regulatory asset in 2008.

SUBSEQUENT EVENTS

Effective June 2009, UNS Electric adopted a policy related to accounting for and disclosure of subsequent events that occur after the balance sheet date but before financial statements are issued. In accordance with this policy, UES evaluated subsequent events occurring through the issuance date in preparing these financial statements.

RECLASSIFICATIONS AND OTHER ADJUSTMENTS**Renewable Energy and Demand Side Management (DSM) Revenues**

UNS Electric reclassified renewable revenue of \$1.5 million in 2008 from Other Revenue to Electric Retail Sales in the Statement of Income. This reclassification had no effect on income.

Dividend Equivalents

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

In September 2009, UNS Electric recorded dividends of less than \$0.1 million for dividend equivalents that should have been recorded between 2005 and 2008.

Purchased Energy

UNS Electric has a Purchased Power and Fuel Adjustment Clause (PPFAC) which allows recovery of actual fuel and purchased power costs, including demand charges, transmission costs, and prudent settlement costs of contracts for hedging fuel and purchased power costs. See Note 3.

To provide more information regarding the components of the PPFAC and to be comparable with the 2009 presentation, UNS Electric made the following reclassifications to the statement of income for the year ended December 31, 2008.

- UNS Electric reclassified Transmission expenses of \$10.6 million in 2008 from Other Operations and Maintenance to Transmission, a component of Total Fuel and Purchased Energy;
- UNS Electric reclassified \$2.7 million in 2008 of over-recovered PPFAC expenses from Purchased Energy, Transmission, and Fuel to Increase (Decrease) to reflect PPFAC Recovery Treatment, a component of Total Fuel and Purchased Energy.

These reclassifications had no effect on Net Income.

Deferred Taxes

UNS Electric reclassified \$0.9 million of AMT Credit deferred taxes in the prior year balance sheet to be comparable with the 2009 presentation. This adjustment increased Deferred Income Tax Liabilities and increased Accounts Receivable – Due from Affiliates. The adjustment had no impact on net income.

RECENTLY ISSUED ACCOUNTING STANDARDS

The following recently issued accounting standards are not yet reflected in the UNS Electric financial statements:

- The FASB issued authoritative guidance for transfers of financial assets that clarify and change the criteria for a transfer to be accounted for as a sale, change the amount of a recognized gain/loss on a sale when beneficial interests are received by the transferor, and requires extensive disclosures. This standard is effective for annual periods beginning January 1, 2010. To date, we have not participated in any transfers to which this guidance is applicable.
- The FASB issued authoritative guidance for variable interest entities requiring an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This standard did not have an impact on our financial statements on adoption on January 1, 2010.
- The FASB issued authoritative guidance for multiple deliverable revenue arrangements that provides another alternative for determining the selling price of deliverables and eliminates the residual method of allocating consideration. In addition, this pronouncement requires expanded qualitative and quantitative disclosures and is effective for revenue arrangements entered into after January 1, 2011. We are evaluating the impact of this pronouncement.
- The FASB issued amendments that require some new disclosures and clarify some existing

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

disclosure requirements about fair value measurements. The amendments are effective for annual reporting periods beginning January 1, 2010, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements, which are effective for annual reporting periods beginning January 1, 2011. We are evaluating the impact of these new and revised disclosures on our financial statements.

NOTE 3. REGULATORY MATTERS

2008 UNS Electric Rate Order

In the May 2008 rate order, the ACC approved a rate increase of 2.5% (\$4 million) effective June 2008. As a result of the May 2008 rate order limiting recovery of deferred rate case costs, UNS Electric expensed \$0.3 million of the \$0.6 million deferred costs in May 2008.

2009 General Rate Case Filing

In April 2009, UNS Electric filed a general rate case with the ACC (on a cost of service basis) requesting a total rate increase of 7.4% to cover a revenue deficiency of \$13.5 million. The case uses a December 31, 2008 test year. Hearings before an ACC administrative law judge concluded in February 2010. UNS Electric expects the ACC to rule on its rate case in the second half of 2010.

Purchased Power and Fuel Adjustment Clause (PPFAC)

UNS Electric's retail rates include a PPFAC, which allows for a separate surcharge or surcredit to the base rate for delivered purchased power to collect under-recovered or return over-recovered costs. Allowable PPFAC costs include fuel, purchased power (less proceeds from most wholesale sales) and transmission costs. The PPFAC approved in UNS Electric's last rate case in May 2008, allows recovery of fuel and purchased power costs incurred to provide service to retail ratepayers, including demand charges and the prudent costs of contracts for hedging fuel and purchased power costs.

The PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on the difference between forecasted fuel and purchased power costs and the base cost of fuel and purchased power included in base rates. The true-up component reconciles the previous year's actual fuel and purchased power costs with the amounts collected through base and PPFAC rates and credits or recovers that amount to or from customers in the subsequent PPFAC year. The PPFAC rate will be updated on June 1 of each year, beginning June 1, 2009.

On June 1, 2009, a PPFAC credit of approximately 1.06 cents per kWh took effect. The PPFAC rate from June 1, 2008 to May 31, 2009, was a charge of approximately 1.5 cents per kWh. Base rates of approximately 7.1 cents per kWh have been in effect since June 1, 2008. The retail rates prior to June 2008, included a charge for fuel and purchased power of approximately 7 cents per kWh (base rate recovery of 5.2 cents per kWh and a transmission surcharge of 1.8 cents per kWh).

The following table shows the balance of over-recovered purchased power costs:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
(Over) Under Recovered Purchased Power Costs – Regulatory Basis as Billed to Customers	\$ (823)	\$ 308
Estimated Purchased Power Costs Recovered through Accrued Unbilled Revenues	(3,930)	(6,767)

UNS ELECTRIC, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Over-Recovered Purchased Power Costs (PPFAC) Included as a Current Regulatory Liability	\$ (4,753)	\$ (6,459)
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Purchased Power Agreement

In June 2008, UED and UNS Electric entered into a 5-year Power Purchase Agreement (PPA) under which UED sells all the output of BMGS to UNS Electric. The PPA is a tolling arrangement in which UNS Electric takes operational control of BMGS and assumes all risk of operation and maintenance costs, including fuel. UNS Electric accounts for the PPA as an operating lease. The costs associated with the PPA are recoverable through UNS Electric's PPFAC.

Regulatory Assets and Liabilities

In addition to over-recovered purchased power costs, UNS Electric's regulatory assets and liabilities were as follows:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Current Regulatory Assets		
Derivatives Instruments	\$ 9,268	\$ 16,571
Self-Insured Medical and Short-Term Disability Assets	150	260
Demand-Side Management (DSM) Assets	80	-
Other Regulatory Assets		
Derivatives Instruments	2,344	7,214
Pension and Other Postretirement Benefits	1,918	2,575
Rate Case Costs	442	242
Current Regulatory Liabilities		
REST	(531)	(871)
Demand-Side Management (DSM)	-	(207)
Other Regulatory Liabilities		
Net Cost of Removal for Interim Retirements	(11,970)	(10,548)

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Derivative instruments represent the unrealized gains or losses on contracts entered into to hedge the variability of purchased energy costs that are expected to be recovered through the PPFAC. UNS Electric does not earn a return on these costs.
- Self-Insured Medical and Short-Term Disability assets are recorded based on historical ratemaking treatment allowing UNS Electric to recover self-insured medical costs and short-term disability costs on a pay-as-you-go or cash basis. While these assets do not earn a return, they are fully recovered in rates over an approximate one-year period.
- The ACC has approved a DSM surcharge which is intended to cover UNS Electric's DSM programs such as Low Income Weatherization. Qualified DSM expenditures in excess of the surcharge will be reflected as a current regulatory asset. Conversely, any surcharge collected in excess of qualified DSM expenditures will be reflected in the financial statements as a current regulatory liability.
- Pension and Other Postretirement Benefits represent the unfunded status of UNS Electric's share of the UES pension and other postretirement benefit plans that it expects, based on past regulatory actions, to recover through rates. UNS Electric does not earn a return on these costs.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

- Rate case costs included in Other Regulatory Assets are included in rate base and consequently earn a return. The recovery period is 3 years.

Regulatory liabilities represent items that UNS Electric expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

- Renewable Energy Standards Tariff (REST) represents the REST surcharge collected in excess of qualified renewable expenditures. The ACC approved a REST surcharge for UNS Electric, effective June 1, 2008, to allow UNS Electric to recover the cost of qualified renewable expenditures, such as payments to customers who have renewable energy resources or the incremental cost of renewable power generated or purchased by UNS Electric. Any surcharge collected in excess of qualified renewable expenditures will be reflected in the financial statements as a current regulatory liability. Conversely, qualified renewable expenditures in excess of the REST surcharge will be reflected as a current regulatory asset. The REST plan includes an adjustor mechanism which allows UNS Electric to file an application with the ACC to apply any shortage or surplus in the prior year's program expenses to the subsequent year's REST surcharge.
- Net Cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations. These are amounts collected through revenue for the net cost of removal of interim retirements for which removal costs have not yet been expended.

Income Statement Impact of Applying Regulatory Accounting

If UNS Electric had not applied regulatory accounting, net income would have been \$7 million higher in 2009, as UNS Electric would have been able to recognize over-recovered purchased power costs and unrealized gains on its commodity derivative instruments as a credit to its expenses in the income statement rather than record an increase to regulatory liabilities. If UNS Electric had not applied regulatory accounting, net income would have been \$15 million lower in 2008 as UNS Electric would have recognized under-recovered purchased energy and unrealized losses on its commodity derivative instruments as an expense to its income statement, rather than as regulatory assets or a reduction to its regulatory liabilities.

Future Implications of Discontinuing Application of Regulatory Accounting

UNS Electric regularly assesses whether it can continue to apply regulatory accounting to its operations. If UNS Electric stopped applying regulatory accounting to its regulated operations, regulatory pension assets would be reflected in AOCI and it would write-off the remaining related balances of its regulatory assets as an expense and would write-off its regulatory liabilities as income on its income statement. Based on the regulatory asset and liability balances, if UNS Electric had stopped applying regulatory accounting to its regulated operations, it would have recorded an extraordinary after-tax gain of \$3 million and an after-tax loss in AOCI of \$1 million at December 31, 2009. Discontinuing application of regulatory accounting would not affect UNS Electric's cash flows.

NOTE 4. UTILITY PLANT

The following table shows Utility Plant in Service and depreciable lives by major class at December 31:

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

	2009	2008	Depreciable Lives
	-Thousands of Dollars-		
Plant in Service:			
Electric Generation Plant	\$ 17,072	\$ 16,775	38 – 49 years
Electric Distribution Plant	185,410	163,511	23 – 50 years
Electric Transmission Plant	30,534	29,331	20 – 50 years
General Plant	10,922	9,173	5 – 40 years
Intangible Plant	4,318	4,193	15 – 32 years
Computer Software	88	115	5 years
Total Plant in Service	\$ 248,344	\$223,098	
Utility Plant under Capital Leases	\$ 706	\$ 706	

Intangible Plant is principally comprised of transmission access rights.

NOTE 5. DEBT, CREDIT FACILITIES AND CAPITAL LEASE OBLIGATIONS

LONG-TERM DEBT

UNS Electric has \$100 million of senior unsecured notes outstanding, consisting of \$50 million at 6.5%, due 2015 and \$50 million at 7.1%, due 2023. The notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. Treasury security yield plus 50 basis points. UES guarantees the notes.

The UNS Electric note agreements contain certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, dividends or distributions on common stock and incurrence of indebtedness. As of December 31, 2009, UNS Electric was in compliance with the covenants.

The incurrence of indebtedness covenant requires UNS Electric to meet certain tests before additional indebtedness may be incurred. These tests include:

- A ratio of Consolidated Long-Term Debt to Consolidated Total Capitalization of no greater than 65%.
- An Interest Coverage Ratio (a measure of cash flow to cover interest expense) of at least 2.50 to 1.00.

However, UNS Electric may, without meeting these tests, refinance indebtedness and incur short-term debt in an amount not to exceed \$5 million. If UNS Electric complies with the terms of its note agreements, UNS Electric may pay dividends to UES.

The senior unsecured notes may be accelerated upon the occurrence and continuance of an event of default such as failure to make required payments, certain events of bankruptcy, reorganization proceedings or a change of control of UES or UNS Electric.

CAPITAL LEASE OBLIGATIONS

UNS Electric has two trucks under capital leases with initial terms to 2011. Both leases may be continued with the same rental terms until either party gives 90 days notice; and they each provide for the purchase

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

of the leased asset at fair market value at the end of the lease.

The following provides future payments on UNS Electric's capital lease obligations at December 31, 2009:

	Capital Lease Obligations
	-Thousands of Dollars-
2010	\$ 115
2011	38
Total 2010-2011	153
Imputed Interest	(6)
Total	\$ 147

REVOLVING CREDIT AGREEMENT

The UNS Gas/UNS Electric Revolver is a \$60 million revolving credit facility which matures in August 2011. Either UNS Gas or UNS Electric may borrow up to a maximum of \$45 million, so long as the combined amount borrowed does not exceed \$60 million. UNS Gas is only liable for UNS Gas' borrowings, and similarly, UNS Electric is only liable for UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver. UES guarantees the obligations of both UNS Gas and UNS Electric. The revolver may be used to issue letters of credit, as well as for revolver borrowings. The letters of credit issued support power and gas purchases and hedges and are off-balance sheet obligations for UNS Electric.

UNS Electric has the option of paying interest at LIBOR plus 1.0% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate on revolver borrowings.

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, dividends, mergers and sales of assets. The UNS Gas/UNS Electric Revolver also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. As of December 31, 2009, UNS Electric was in compliance with the terms of the UNS Gas/UNS Electric Revolver.

The borrowings by UNS Electric under the UNS Gas/Electric Revolver were as follows:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Balance on the Revolver	\$ -	\$ 8,000
Weighted Average Interest Rate	-	1.5%
Outstanding Letters of Credit	\$ 10,500	\$ 6,500

At December 31, 2008, UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver were excluded from Current Liabilities and presented as Long-Term Debt, as UNS Electric had the ability and the intent to keep the borrowings outstanding under the UNS Gas/UNS Electric Revolver for the next twelve months.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 6. COMMITMENTS AND CONTINGENCIES

UNS Electric records liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties and other sources when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

PURCHASE COMMITMENTS

At December 31, 2009, UNS Electric had various firm non-cancelable purchase commitments as described in the table below.

	2010	2011	2012	2013	Thereafter	Total
	-Thousands of Dollars-					
Purchased Power	\$ 66,900	\$ 23,353	\$ 13,591	\$ 47,514	-	\$ 151,358
Transmission	2,592	1,764	882	-	-	5,238
Total Unrecognized Firm Commitments	\$ 69,492	\$ 25,117	\$ 14,473	\$ 47,514	-	\$ 156,596

UNS Electric enters into agreements with various energy suppliers for purchased power at market prices to meet energy requirements. In general, these contracts provide for capacity payments and energy payments based on actual power taken under the contracts. These contracts expire in various years through 2013. Certain of these contracts are at a fixed price per MW and others are indexed to natural gas prices. The commitment amounts included in the table above are based on market prices as of December 31, 2009.

UNS Electric imports the power it purchases over the Western Area Power Administration's (WAPA) transmission lines. UNS Electric's transmission capacity agreements with WAPA provide for annual rate adjustments and expire in 2011 and 2017. However, the effects of both purchased power and transmission cost adjustments are mitigated through a purchased power rate-adjustment mechanism.

In 2008, to supply gas to the BMGS, UNS Electric entered into a gas supply and a transportation agreement with UNS Gas. These contracts expire in 2028. Additionally, UNS Electric contracted to pay monthly pipeline capacity charges to UNS Gas through February 2020. These firm commitments to UNS Gas are as follows:

	2010	2011	2012	2013	2014	Thereafter	Total
	-Thousands of Dollars-						
Transportation Agreement	\$ 569	\$ 569	\$ 569	\$ 568	\$ 568	\$ 7,486	\$ 10,329
Capacity Charges	766	766	768	766	766	3,913	7,745
Firm Commitments to UNS Gas	\$ 1,335	\$ 1,335	\$ 1,337	\$ 1,334	\$ 1,334	\$ 11,399	\$ 18,074

UNS Electric has entered into one long-term purchase power agreement with a renewable energy generation facility, with ACC approval, that extends for 20 years. The facility is expected to begin commercial operation in 2011. UNS Electric is required to purchase the full output of the facility with an expected minimum capacity of 7 MW. UNS Electric is only obligated to pay for actual energy delivered. There is no minimum payment obligation under this contract.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

OPERATING LEASES

UNS Electric has entered into operating leases, primarily for office facilities and office equipment, with varying terms, provisions, and expiration dates. In addition, in June 2008, UNS Electric entered into a 5-year Power Purchase Agreement (PPA) with UED, which UNS Electric accounts for as an operating lease.

UNS Electric's estimated future minimum payments under non-cancelable operating leases at December 31, 2009 were:

	2010	2011	2012	2013	2014	Thereafter	Total
	-Thousands of Dollars-						
Operating Leases	\$10,531	\$10,530	\$10,338	\$ 4,335	\$ 23	-	\$35,757

UNS Electric's operating lease expense was \$10.5 million in 2009 and \$6.4 million in 2008, of which \$10.3 million and \$6.0 million, respectively, represented expense recorded under the PPA with UED.

ENVIRONMENTAL CONTINGENCIES

UNS Electric owns and operates the Valencia Power Plant (Valencia), located in Nogales, Arizona. The Valencia plant consists of four gas and diesel-fueled combustion turbine units. UNS Electric has continued efforts initiated by the site's previous owner to remediate the soil and groundwater contamination at its Valencia facility. The initial estimate for the cost of remediation, accrued when the plant was acquired, was \$0.6 million. The ultimate cost, however, will depend on the extent of contamination found as the project progresses and when final remediation occurs. UNS Electric is currently conducting a study to determine the source of contamination and is unable to estimate the final impact. Under the purchase agreement for Valencia, UNS Electric's obligation is limited to \$1.5 million. To date UNSE has expended \$0.6 million.

GUARANTEES AND INDEMNITIES

UES guaranteed \$100 million of senior unsecured notes issued by UNS Electric and the \$60 million UNS Gas/UNS Electric Revolver. See Note 5. We believe that the likelihood UES would be required to perform or otherwise incur any significant losses associated with these guarantees is remote.

NOTE 7. INCOME AND OTHER TAXES

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the entire deferred tax asset will not be realized. Management believes that based on the historical pattern of taxable income, UNS Electric will produce sufficient taxable income in the future to realize its deferred tax assets. As a result, no valuation allowance has been recorded on the deferred income tax assets for the years ended December 31, 2009 and December 31, 2008.

UniSource Energy includes UNS Electric's taxable income in its consolidated federal income tax return. Deferred tax assets (liabilities) consist of the following:

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Gross Deferred Income Tax Liabilities		
Plant		
Other	\$ (14,978)	\$ (10,391)
Gross Deferred Income Tax Liabilities	(206)	(124)
Gross Deferred Income Tax Assets	(15,184)	(10,515)
Customer Advances		
Contributions in Aid of Construction	5,376	5,005
Compensation and Benefits	3,952	2,002
Other	1,094	758
	634	546
Gross Deferred Income Tax Assets	11,056	8,311
Net Deferred Income Tax Assets (Liabilities)	\$ (4,128)	\$ (2,204)

The net deferred income tax asset (liability) is included in the balance sheet in the following accounts:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Deferred Income Taxes – Current Assets	\$ 882	\$ 704
Deferred Income Taxes – Noncurrent Liabilities	(5,010)	(2,908)
Net Deferred Income Tax Asset (Liability)	\$ (4,128)	\$ (2,204)

Income tax expense (benefit) included in the income statement includes amounts both payable currently and deferred for payment in future periods as indicated below:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Current Tax Expense (Benefit)		
Federal		
State	\$ 1,239	\$ (4,404)
Deferred Tax Expense	641	(80)
Federal		
State	1,841	6,051
	32	842
Total Federal and State Income Tax Expense	\$ 3,753	\$ 2,409

The following reconciles the provision for income taxes at the federal statutory rate of 35% to the effective rate:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Federal Income Tax Expense at Statutory Rate	\$ 3,389	\$ 2,159
State Income Tax Expense, Net of Federal Deduction	437	285
Other	(73)	(35)
Total Federal and State Income Tax Expense	\$ 3,753	\$ 2,409

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

UNS Electric's net intercompany receivable from affiliates for income taxes equals \$.2 million at December 31, 2009. UNS Electric includes these amounts in intercompany accounts receivable on the balance sheet.

Uncertain Tax Positions

Accounting guidance requires us to determine whether it is "more likely than not" that we will sustain a tax position under examination. Each uncertain tax position is measured to determine the amount of benefit to recognize in the financial statements.

At the end of 2009 and 2008, UNS Electric has no uncertain tax positions.

NOTE 8. PENSION AND POSTRETIREMENT BENEFIT PLANS

UNS Electric does not maintain a separate pension plan or other postretirement benefit plan for its employees. All regular employees are eligible to participate in the pension plan maintained by our parent, UES. A small group of active employees are also eligible to participate in a postretirement medical benefit plan. UES allocates net periodic benefit cost based on service cost for participating employees.

PENSION PLAN

The noncontributory, defined benefit pension plan (the Plan) provides benefits based on years of service and the employee's average compensation. UNS Electric recognizes its share of the underfunded status of the UES defined benefit pension plan as a liability on its balance sheets. The underfunded status is measured as the difference between the fair value of the plan's assets and the projected benefit obligation for pension plans. UNS Electric recognizes a regulatory asset to the extent these future costs are probable of recovery in rates.

Pension Contributions

The Pension Protection Act of 2006 (The Pension Act) establishes minimum funding targets for pension plans beginning in 2008. A plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. While the annual targets are not legally required, if a plan does not meet the annual funding targets, the plan's benefit payment options are limited and a funding deficiency notice must be sent to all plan participants. The UES pension plan is in compliance with The Pension Act.

In 2010, UNS Electric expects to contribute \$0.8 million to the pension plan.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Electric provides postretirement medical benefits for current retirees and a small group of active employees. Beginning in 2008, UNS Electric records changes in its other postretirement obligation, not yet reflected in net periodic benefit cost, as a regulatory asset; as such amounts are probable of future recovery in rates. Amounts previously recorded in AOCI were reclassified to a regulatory asset in 2008.

The pension and other postretirement benefit related amounts (excluding tax balances) included in UNS Electric's balance sheet are:

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Pension Benefits		Other Postretirement Benefits	
	December 31,			
	2009	2008	2009	2008
	-Thousands of Dollars-			
Regulatory Pension Asset included in Regulatory Assets	\$1,806	\$2,478	\$ 112	\$ 97
Accrued Benefit Liability included in Accrued Employee Expenses	-	-	(95)	(77)
Accrued Benefit Liability included in Deferred Employee Benefits	(2,385)	(3,015)	(508)	(572)
Net Amount Recognized	\$ (579)	\$ (537)	\$ (491)	\$ (552)

OBLIGATIONS AND FUNDED STATUS

UNS Electric measured the actuarial present values of all pension benefit obligations and other postretirement benefit plans at December 31, 2009 and December 31, 2008. The previous measurement date was December 1. As a result of the change in the measurement date, we recorded a loss of less than \$0.1 million to retained earnings in January 2008.

The tables below reflect UES' plan information as a whole. The change in projected benefit obligation and plan assets and reconciliation of the funded status are as follows:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2009	2008	2009	2008
	-Thousands of Dollars-			
Change in Projected Benefit Obligation				
Benefit Obligation at Beginning of Year	\$10,485	\$ 7,352	\$ 1,194	\$ 1,154
Actuarial (Gain) Loss	(168)	1,833	34	277
Interest Cost	651	501	73	77
Service Cost	1,101	917	-	-
Measurement Date Change	-	118	-	-
Benefits Paid	(625)	(236)	(158)	(314)
Projected Benefit Obligation at End of Year	11,444	10,485	1,143	1,194
Change in Plan Assets				
Fair Value of Plan Assets at Beginning of Year	3,937	4,889	-	-
Actual Return on Plan Assets	1,241	(1,951)	-	-
Benefits Paid	(625)	(236)	(198)	(362)
Employer Contributions	1,588	1,200	165	314
Participant Contributions	-	-	40	48
Measurement Date Change	-	35	-	-
Fair Value of Plan Assets at End of Year	6,141	3,937	7	-
Funded Status at End of Year	\$ (5,303)	\$ (6,548)	\$ (1,136)	\$ (1,194)

At December 31, 2009, UNS Electric's proportionate share of the pension plan's funded status is approximately 45%.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table provides the components of UES' regulatory assets that have not been recognized as components of periodic benefit cost as of December 31, 2009:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Net Loss	\$ 2,029	\$ 240
Prior Service Cost (Benefit)	1,744	(33)

The accumulated benefit obligation for the UES defined benefit pension plan was \$8.8 million at December 31, 2009 and \$6.8 million at December 31, 2008. At December 31, 2009 and 2008, the UES defined benefit pension plan had accumulated benefit obligations in excess of plan assets.

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Projected Benefit Obligation at End of Year	\$ 11,444	\$ 10,485
Accumulated Benefit Obligation at End of Year	8,797	6,760
Fair Value of Plan Assets at End of Year	6,141	3,937

As of December 31 the components of UES' net periodic benefit costs are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
	-Thousands of Dollars-			
Components of Net Periodic Cost				
Service Cost	\$ 1,101	\$ 917	\$ -	\$ -
Interest Cost	651	501	74	71
Expected Return on Plan Assets	(356)	(430)	-	-
Prior Service Cost Amortization	258	258	(3)	(3)
Recognized Actuarial (Gain) Loss	176	(19)	8	-
Net Periodic Benefit Cost	\$ 1,830	\$ 1,227	\$ 79	\$ 68

In 2009, UNS Electric recognized 46% of total net periodic pension benefit costs and 53% of other postretirement benefit costs based on relative employee participation.

A portion of the net periodic benefit cost was capitalized as a cost of construction and the remainder was included in Other Operating and Maintenance costs.

The amounts recognized by UES as regulatory assets or in AOCI are as follows:

UNS ELECTRIC, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Changes in Plan Assets and Benefit Obligations Recognized as Regulatory Asset	Pension Benefits	
	2009	2008
	-Thousands of Dollars-	
Current Year Actuarial (Gain) Loss	\$ (1,053)	\$ 4,214
Amortization of Actuarial Gain (Loss)	(176)	19
Prior Service (Cost) Amortization	(258)	(258)
Measurement Plan Change	-	(20)
Total Recognized as Regulatory Asset	\$ (1,487)	\$ 3,955

	Other Postretirement Benefits		
	Regulatory Asset	Regulatory Asset	AOCI
	2009	2008	
-Thousands of Dollars-			
Changes in Benefit Obligation Recognized as Regulatory Assets or in AOCI			
Current Year Actuarial (Gain) Loss	\$ 33	\$ 277	\$ -
Amortization of Actuarial Gain (Loss)	(8)	-	-
Prior Service (Cost) Amortization	3	-	3
Reclassification from AOCI to Regulatory Asset	-	(99)	99
Total Recognized as Regulatory Assets or in AOCI	\$ 28	\$ 178	\$ 102

For the pension plan, we amortize prior service costs on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan. UES will amortize \$0.3 million of prior service cost and \$0.2 million of net loss from regulatory assets into net periodic benefit cost in 2010. The estimated net loss and prior service benefit for the defined benefit postretirement plans that will be amortized from regulatory assets into net periodic benefit cost in 2010 are less than \$0.1 million, respectively.

Weighted-Average Assumptions Used to Determine Benefit Obligations as of the Measurement Date,

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
Discount Rate	6.3%	6.3%	6.0%	6.5%
Rate of Compensation Increase	3.00 – 4.00%	3.00 – 4.00%	N/A	N/A

Weighted-Average Assumptions Used to Determine Net Periodic Benefit Costs for Years Ended December 31,

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
Discount Rate	6.3%	6.8%	6.5%	6.5%
Rate of Compensation Increase	3.00 – 4.00%	3.00 – 4.00%	-	-
Expected Return on Plan Assets	8.0%	7.75%	-	-

Net periodic benefit cost is subject to various assumptions and determinations, such as the discount rate, the rate of compensation increase, and the expected return on plan assets. UES uses a combination of sources in selecting the expected long-term rate-of-return-on-assets assumption, including an investment

UNS ELECTRIC, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

return model. The model used provides a "best estimate" range over 20 years from the 25th percentile to the 75th percentile. The model used as a guideline for selecting the overall rate-of-return-on-assets assumption is based on forward looking return expectations only. The above method is used for all asset classes.

Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as net periodic benefit cost.

	2009	December 31, 2008
Assumed Health Care Cost Trend Rates		
Health Care Cost Trend Rate Assumed for Next Year	7.9%	7.5%
Ultimate Health Care Cost Trend Rate Assumed	4.5%	5.0%
Year that the Rate Reaches the Ultimate Trend Rate	2027	2017

A one-percentage-point change in assumed health care cost trend rates would have an impact of less than \$0.1 million on UES' benefit obligation on the December 31, 2009 amounts reported.

Pension Plan Assets

UES calculates the market-related value of plan assets using the fair value of plan assets on the measurement date. The pension plan asset allocations by asset category are as follows:

	Plan Assets	
	December 31,	
Asset Category	2009	2008
Equity Securities	56%	67%
Fixed Income Securities	33%	31%
Real Estate	11%	-
Cash	-	2%
Total	100%	100%

The policy for the UES pension plan is to provide exposures to equity and debt securities by investing in a balanced fund.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Fair Value Measurements of Pension Assets				
December 31, 2009				
-Thousands of Dollars-				
Asset Category	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobserva ble Inputs (Level 3)	Total
Cash	\$ 2	\$ -	\$ -	\$ 2
Equity Securities:				
U.S. Large Cap	-	1,729	-	1,729
U.S. Small Cap	-	340	-	340
Non-U.S.	-	1,341	-	1,341
Fixed Income	-	2,049	-	2,049
Real Estate	-	680	-	680
Total	\$ 2	\$ 6,139	\$ -	\$ 6,141

Level 1 cash equivalents are based on observable market prices and are comprised of the fair value of commercial paper, money market funds, and certificates of deposit.

Level 2 investments comprise amounts held in co-mingled equity, US bond and real estate funds. Valuations are based on active market quoted prices for assets held by each respective fund.

Pension Plan Investments

Investment Goals

Strategic asset allocation is the principal method for achieving the plan's investment objective, while maintaining an appropriate level of risk. We will consider the projected impact on benefit security of any proposed changes to the current asset allocation policy. The expected long-term returns and implications for funding will be reviewed in selecting policies to ensure that current asset pools are projected to be adequate to meet the expected liabilities of the Plan. We expect to use asset allocation policies weighted most heavily to equity and fixed income funds, while maintaining some exposure to real estate and opportunistic funds. Within the fixed income allocation, long-duration funds may be used to partially hedge interest rate risk. The plan seeks to provide returns in excess of a portfolio benchmark.

Risk Management

We recognize the difficulty of achieving investment objectives in light of the uncertainties and complexities of the investment markets. We also recognize some risk must be assumed to achieve a Plan's long-term investment objectives. In establishing risk tolerances, the following factors affecting risk tolerance and risk objectives will be considered: 1) Plan status; 2) UES' financial status and profitability; 3) Plan features; and 4) workforce characteristics. We have determined that the Plan can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives. We track the plan's portfolio relative to the benchmark through quarterly investment reviews. The reviews consist of a performance and risk assessment of all investment managers and on the portfolio as a whole.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Investment managers for the plan may use derivative financial instruments for risk management purposes or as part of their investment strategy. Currency hedges have also been used for defensive purposes.

Relationship between Plan Assets and Benefit Obligations

The overall health of the Plan will be monitored by comparing the value of Plan obligations (both Accumulated Benefit Obligation and Projected Benefit Obligation) against the market value of assets and tracking the changes in each. The frequency of this monitoring will depend on the availability of Plan data, but will be no less frequent than annually via annual actuarial valuation.

The current target allocation percentages for the major categories of plan assets follow. There is a range of +/- 2% of the target allocation before the fund will be automatically rebalanced.

	UES Plan %
Fixed Income	33.4%
U.S. Large Cap	27.8%
Non-US Developed	16.7%
Real Estate	11.1%
U. S. Small Cap	5.5%
Non-US Emerging	5.5%
Total	100.0%

Pension Fund Descriptions

All of the funds are based on a manager-of-managers approach. This approach is predicated on a research-driven evaluation of outside money-managers by an independent investment consultant employed by The Plan. The investment consultant is responsible for allocating capital to numerous fund managers based on The Plan's desired asset allocation. For example, there might be 10 different fund managers who are allocated capital under The Plan's Fixed Income allocation by the investment consultant. It is in this manner the investment consultant serves as The Plan's "manager-of-managers".

Estimated Future Benefit Payments

As of December 31 the following benefit payments, which reflect future service, as appropriate, are expected to be paid by UES:

	Pension Benefits	Other Postretirement Benefits
	- Thousands of Dollars -	
2010	\$ 362	\$ 122
2011	673	121
2012	789	118
2013	791	116
2014	906	113
Years 2015-2019	6,839	496

DEFINED CONTRIBUTION PLAN

UNS Electric offers a defined contribution savings plan to all eligible employees. The Internal Revenue Code identifies the plan as a qualified 401(k) plan. Participants direct the investment of contributions to certain funds in their account. UNS Electric matches part of a participant's contributions to the plan. UNS Electric made matching contributions of less than \$0.3 million in each of 2009 and 2008.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 9. FAIR VALUE MEASUREMENTS

The following tables set forth, by level within the fair value hierarchy, UNS Electric's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009 and December 31, 2008. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2009 - Thousands of Dollars -				
Assets				
Cash Equivalents ⁽¹⁾	\$ 9,008	\$ -	\$ -	\$ 9,008
Collateral Posted ⁽²⁾	-	-	-	-
Energy Contracts ⁽³⁾	3	217	4,634	4,854
Total Assets	9,011	217	4,634	13,862
Liabilities				
Energy Contracts ⁽³⁾	(2)	(3,097)	(13,366)	(16,465)
Total Liabilities	(2)	(3,097)	(13,366)	(16,465)
Net Total Assets and (Liabilities)	\$ 9,009	\$ (2,880)	\$ (8,732)	\$ (2,603)

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2008 - Thousands of Dollars -				
Assets				
Cash Equivalents ⁽¹⁾	\$ 4,171	\$ -	\$ -	\$ 4,171
Collateral Posted ⁽²⁾	-	6,620	-	6,620
Energy Contracts ⁽³⁾	-	96	3,007	3,103
Total Assets	4,171	6,716	3,007	13,894
Liabilities				
Energy Contracts ⁽³⁾	-	(8,115)	(18,772)	(26,887)
Total Liabilities	-	(8,115)	(18,772)	(26,887)
Net Total Assets and (Liabilities)	\$ 4,171	\$ (1,399)	\$ (15,765)	\$ (12,993)

(1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and certificates of deposit.

(2) Collateral provided for energy contracts with counterparties to reduce credit risk exposure.

(3) Energy contracts include gasoline/diesel swap agreements (Level 1), natural gas swap agreements (Level 2), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to reduce exposure to energy price risk. The valuation techniques are described below.

Energy Contracts

UNS Electric primarily applies the market approach for recurring fair value measurements and endeavors to utilize the best available information. Where observable inputs are available for substantially the full terms of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange (NYMEX) pricing, adjusted for basin differences, the instrument is categorized in Level 2.

Derivatives valued using an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers are categorized in Level 3. For both power and gas prices, UNS Electric obtains quotes from brokers, major market participants, exchanges or industry publications as well as its own price experience from active transactions in the market. UNS Electric primarily uses one set of quotations each for power and for gas, and then uses the other sources as validation of those prices. The broker providing quotes for power prices states that the market information provided is indicative only, but believes it to be reflective of market conditions as of the time and date indicated. In addition, energy derivatives include contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, UNS Electric applies certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. We also consider the impact of counterparty credit risk using current and historical default and recovery rates as well as our own credit risk using credit default swap data. UNS Electric reviews these assumptions on a quarterly basis.

UNS ELECTRIC, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The fair value of UNS Electric's purchase power call option is estimated using an internal pricing model which includes assumptions about market risks such as liquidity, volatility, and contract valuation. This model also considers credit and non-performance risk. UNS Electric's assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

The following table sets forth a reconciliation of changes in the fair value of forward power purchase contracts classified as Level 3 in the fair value hierarchy for the year ended:

	<u>December 31, 2009</u>
	- Thousands of Dollars -
Balance, beginning of year	\$ (15,765)
Gains and (Losses) (Realized/Unrealized) Recorded to Regulatory Assets/Liabilities	7,033
Balance, end of year	<u>\$ (8,732)</u>

Gains and losses on mark-to-market contracts include the reclassification of realized gains and losses on the settlement of derivative contracts. All of the Level 3 unrealized gains and losses are attributable to the change in fair value of Level 3 assets and liabilities held at the reporting date.

There were no transfers in or out of Level 3 derivatives.

NOTE 10. COMMON STOCK EQUITY**DIVIDEND RESTRICTIONS**

The terms of UNS Electric's senior unsecured note agreements contain dividend restrictions. See Note 5. UNS Electric made no dividend payments to UES in 2009 or in 2008.

CAPITAL CONTRIBUTIONS

UES made capital contributions to UNS Electric of \$0.3 million in 2008. No additional capital contributions were made in 2009.

UNS ELECTRIC, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of net income to net cash flows from operating activities follows:

	Years Ended December 31,	
	2009	2008
	-Thousands of Dollars-	
Net Income	\$ 5,931	\$ 3,764
Adjustments to Reconcile Net Income to Net Cash Flows		
Depreciation and Amortization Expense	14,012	13,574
Depreciation Recorded to Other Operations & Maintenance Expense	678	568
Amortization of Deferred Debt-Related Costs Included in Interest Expense	96	154
Provision for Bad Debts	562	1,201
Deferred Income Taxes	1,872	6,893
Pension and Postretirement Expense	878	608
Pension and Postretirement Funding	(896)	(798)
Over Recovered Purchased Energy Costs	(1,734)	(2,745)
Changes in Assets and Liabilities which Provided (Used)		
Cash Exclusive of Changes Shown Separately		
Accounts Receivable	5,524	(3,098)
Materials and Supplies Inventory	(649)	(1,306)
Cash Collateral Posted for Energy Contracts	6,620	(6,620)
Income Tax Receivable/Payable	108	679
Accounts Payable	629	(1,977)
Interest Accrued	(161)	980
Taxes Accrued	(487)	761
Other	3,990	913
Net Cash Flows – Operating Activities	\$36,973	\$13,551

NOTE 12. ACCOUNTING FOR DERIVATIVE INSTRUMENTS, TRADING ACTIVITIES AND HEDGING ACTIVITIES

See Note 2 for description of our related accounting policies.

Regulatory Treatment of Commodity Derivatives

UNS Electric reports unrealized gains and losses on energy contracts that are recoverable through the PPFAC on the balance sheet as a regulatory asset or a regulatory liability rather than as a component of AOCI or in the income statement. UNS Electric recorded decreases to regulatory balances of \$12.2 million and increases to regulatory balances of \$32.6 million in 2009 and 2008, respectively. Realized gains and losses on settled gas swaps are fully recovered through the PPFAC. In 2009 and 2008, UNS Electric had realized losses of \$11.6 million and \$0.6 million, respectively.

At December 31, 2009, UNS Electric had contracts that will settle through the fourth quarter of 2013.

UNS ELECTRIC, INC.
NOTES TO FINANCIAL STATEMENTS (concluded)

Derivative Volumes

At December 31, 2009, UNS Electric had gas contracts totaling 2,577 GBtu and power contracts totaling 2,612 GWh which were accounted for as derivatives.

Credit Risk Adjustment

When the fair value of our derivative contracts are reflected as an asset, the counterparty owes us and this creates credit risk. We minimize our credit risk by (1) entering into transactions with high-quality counterparties; (2) limiting our exposure to each counterparty; (3) monitoring the financial condition of the counterparties; and (4) requiring collateral in accordance with the counterparty master agreements. Using a combination of market credit default swap data and historical recovery rates for subordinated bonds, we consider the impact of counterparty credit worthiness in determining the fair value of our derivatives. At December 31, 2009, and December 31, 2008, the impact of counterparty credit risk on the fair value of derivative asset contracts was less than \$0.5 million.

We also consider the impact of our own credit risk on instruments that are in a net liability position. We calculate the impact using market credit default swap data, after deducting collateral posted, and allocate the credit risk adjustment to all individual contracts in a net liability position. At December 31, 2009, and December 31, 2008, the impact of our own credit risk was less than \$0.5 million.

Concentration of Credit Risk

The use of contractual arrangements to manage the risks associated with changes in energy commodity prices creates credit risk exposure resulting from the possibility of nonperformance by counterparties pursuant to the terms of their contractual obligations. UNS Electric enters into contracts for the physical delivery of energy which contain remedies in the event of non-performance by the supply counterparties. In addition, volatile energy prices can create significant credit exposure from energy market receivables and mark-to-market valuations.

UNS Electric has contractual agreements for its energy procurement and hedging activities that contain certain provisions that require it to post collateral under certain circumstances. These circumstances include credit rating downgrades, or a failure to meet certain financial ratios. In the event that such credit events were to occur, UNS Electric would have to provide certain credit enhancements in the form of cash or letters of credit to fully collateralize its exposure to these counterparties.

The following table shows the sum of the fair value of all derivative instruments along with net payable position under contracts with credit-risk-related contingent features that are in a net liability position at December 31, 2009. It also shows cash collateral and letters of credit posted, and additional collateral to be posted if credit-risk related contingent features were triggered.

	UNS Electric
	December 31, 2009
	-Thousands of Dollars-
Net Liability Position	\$ 20,364
Cash Collateral Posted	-
Letters of Credit	10,500
Additional Collateral to Post if Contingent Features	14,081

At December 31, 2009, UNS Electric had immaterial exposure to other counterparties.